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C O N F I D E N T I A L SECTION 01 OF 05 TEGUCIGALPA 003184

SIPDIS

STATE FOR WHA, WHA/CEN AND EB/CBA
GUATEMALA FOR COMATT: DTHOMPSON

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TAGS: ENRG BEXP EINV ECON EAID PREL HO
SUBJECT: AES AND ELECTRICITY TENDER: GOH AWARDS TO LUFUSSA
DESPITE FAILURE TO COMPLY WITH BID REQUIREMENTS

REF: A. (A) 01 TEGUCIGALPA 2872

1B. (B) TEGUCIGALPA 02207
1C. (C) TEGUCIGALPA 02857

Classified By: Ambassador Larry Palmer; Reasons 1.5 (B) and (D).

SUMMARY

11. (C) The Honduran state-owned electricity company ENEE announced that Honduran company Lufussa was the winner of the 210MW electricity tender, ignoring Lufussa's failure to comply with bid requirements and serious allegations of impropriety. ENEE's decision represents a heavy blow for U.S. company AES, which seeks to build a USD 600 million combined cycle plant producing 850 MW of energy, fueled by liquefied natural gas. AES has identified a number of weaknesses in the decision and plans to challenge the contract award through administrative and judicial channels, if necessary. The GOH has not adequately explained these apparent discrepancies to date. Embassy recommends that the USG support AES in its challenge of the bid results. While post does not necessarily recommend a direct linkage between this issue and USG assistance, it would be helpful to delay any announcements of new assistance or initiatives at this time. End Summary.

ENEE ANNOUNCES LUFUSSA BEAT OUT AES, WITHOUT SUBSTANTIATION

12. (C) On November 15, the Board of Directors of the state-owned electricity company ENEE announced Honduran company Lufussa (owned by the Kafie family) was the winner of the 210MW electricity tender. ENEE indicated that Lufussa had provided the lowest evaluated price per kilowatt hour of \$.04638, followed by Comercial Laeizz at \$.04797, AES at \$.04825, ENERSA at \$.04847, NAINSA at \$.05078 and El Triunfo at \$.05337. No documentation was provided on the assumptions underlying these calculations. The official notification of the results was delivered to the bidders on November 19.

13. (C) ENEE's decision, if not overturned, represents a heavy blow for U.S. company AES, which seeks to build a USD 600 million combined cycle plant producing 850 MW of energy, fueled by liquefied natural gas. Successful acquisition of this contract would have provided AES sufficient security of demand, along with its contracts in El Salvador, to complete financing arrangements and begin construction of the plant and LNG terminal. AES is concerned about perceived irregularities and a lack of transparency in the evaluation process. They continue to seek the supporting documentation. Post expects the company to issue a challenge to the bid award by November 26. If the appeal is denied and AES decides to sue in the courts for redress, this challenge could tie up the tender for months or even years, thus delaying the GOH's phase-out of extremely expensive short-term electricity contracts.

14. (C) The USG (both at the Embassy and in Washington) has heavily advocated for a fair and transparent process (ref c). In the past month, Embassy approaches have been complemented by letters from Commerce Secretary Evans and Under Secretary of State for Economic, Business and Agricultural Affairs Alan Larson. EmbOffs have been repeatedly assured by numerous high level Honduran officials, including President Maduro, of their commitment to a transparent and technically correct process. Nonetheless, serious flaws in the GOH's management of the process have emerged.

15. (C) On November 18, Minister of the Presidency Luis Cosenza and presidential counselor Ramon Medina Luna met with Ambassador and DCM to explain the GOH's position on the results of the project. Cosenza started by explaining the process used to ensure fairness and transparency - the Evaluation Committee included representatives from Probidad Administrativa (the GOH's ethics office), the Attorney General's office, and the Controleria (akin to the OMB or GAO). A transparency committee of outside observers was also formed to certify that all procedures were followed

correctly. There was unanimity among all the representatives on the results of the bid. Given this unanimity, Cosenza asserted that there was no defendable way for the Board of Directors of ENEE to disregard the recommendation or for the President to refuse to sign off on it. Cosenza also explained that there was a five-week delay in announcement of the bid results to accommodate a request from new officials in Probidad Administrativa to have time to review the whole process. Although the GOH was aware that the delay would add to questions about the fairness of the process, it was necessary to let Probidad's review take its course.

¶6. (C) During the meeting with Cosenza, Ambassador and DCM questioned the lack of availability of the data on which the decision was based, the lack of action on allegations of impropriety, and the failure to disqualify national firms early in the process who failed to meet the minimum requirements of the bid. Cosenza was apparently nervous and defensive throughout the meeting, but did not acknowledge GOH failings in these areas. At the end of the meeting, Cosenza offered to send the members of the transparency committee to the Embassy to brief the Ambassador personally. The meeting is scheduled to take place on Friday morning, November 22.

AREAS OF CONCERN

¶7. (C) AES has identified a number of categories of problems in the transparency and fairness of the bid process, including lack of transparency and data, unfair evaluation criteria, and a lack of action by the GOH on possible corruption among the participants in the evaluation. The GOH's responses have been legalistic and vague, to date.

Unsubstantiated Price Calculations

¶8. (C) AES alleges a lack of transparency and fairness on the calculation of evaluated price: no documentation regarding price analysis or methodology has been received to date. In response to separate Embassy and AES inquiries, the GOH has promised that the transparency committee, established by ENEE to monitor the evaluation committee's work, will give briefings on the process. This clearly begs the question. Customarily, an evaluation of price consists of application of a formula based on price bids, estimates on fuel costs and estimates of transmission loss.

¶9. (C) AES calculates that with some assumptions, Lufussa could have had a lower evaluated price before transmission loss, but after transmission loss is taken into account (since its transmission losses should be about 20 percent lower than Lufussa's) AES would come into first place albeit at a small margin. According to AES' calculations, there are no scenarios under which Comercial Laiesz could have had a lower cost. Note: Minister of the Presidency Cosenza and ENEE General Manager Botazzi, although both are electrical engineers, have professed lack of familiarity with the evaluation formula and the results. They claim to have relied totally on the results of the Evaluation Committee and the Transparency Committee. AES terms it "incredible" that the GOH would have announced a winner without even doing a cursory view of the calculations or having the information ready. End Note.

Lack of Disqualification of top bidders for failures of their bids to meet tender package requirements

¶10. (C) AES has strongly argued all along that Lufussa should have been disqualified by ENEE for failure to include in its offer a transmission line and all related infrastructure. Clause 2.1 of the draft contract and Addendum 4 of the package, required transmission lines and all related infrastructure needed to deliver committed capacity and energy be included. According to AES, Lufussa did not make a commitment to build the \$20 million transmission line until it received the second round of requests for clarification by the evaluation committee. In the case of Comercial Laiesz, AES believes that the company's offer of 155 separate 1.7 MW motors does not meet the intent of the ENEE to receive bids for "base load" capacity.

¶11. (C) GOH officials (including Cosenza, ENEE leadership and all participants in the evaluation and transparency committees) are insisting that Honduran law allows Lufussa to remedy the initial lack of transmission capability in a later round of clarifications. AES flatly refutes this, noting that transmission capability was a required technical parameter and a variable that impacts the economic offer and that Lufussa should have been disqualified at that point. The GOH has given no explanation of the lack of disqualification of Comercial Laiesz.

Price Evaluation Methodology

¶12. (C) ENEE issued changes to the price evaluation methodology throughout the spring of 2002, in light of comments and questions made by participants in the tender. AES contested the key points in the methodology (fuel evaluation, variable costs, economic dispatch and others) in a letter on June 5 but received no response from ENEE as required under bid terms.

¶13. (C) AES complains that one of these changes allowed high fuel prices in April 2002 to give a 16 percent advantage on variable fuel costs to the evaluated prices of bidders using bunker fuel (a counterintuitive result since high oil prices should not make a bidder more attractive). Variable fuel costs represent approximately one-half of the overall price. AES' competitors were also given a large advantage when ENEE decided not to take into account the fact that AES' total variable costs are 45 percent lower than Lufussa because of the efficiency of combined cycle technology. The GOH's bland response to these arguments is that ENEE tried to be balanced in deciding on the evaluation criteria, adding that "while some decisions may have worked to AES' disadvantage, others worked in their favor" (e.g. the decision to allow 24 months for plant construction).

GOH Allowed Opportunities for Manipulation of the Process

¶14. (C) AES reports that on at least four separate occasions, individuals purporting to either represent other bidders or to have influence with the GOH have contacted AES regarding the possibility of a negotiated solution, such as dividing the bid among certain participants or suggesting that AES Honduras could be allowed to win, for a fee. On two other occasions, internal documents belonging to the evaluation committee were offered for sale to AES Honduras (and refused). GOH officials acknowledged that they were aware of these allegations but because "they did not affect the final decision" took no action to investigate. AES argues that this lack of action, combined with the GOH's continuous insistence that the process was transparent, sent a message that there would be no serious consequences for such action.

AES had the better project

¶15. (C) AES argues that any of the above factors should have allowed the ENEE and GOH to award the contract to AES. In addition, AES thinks that the government should have considered the additional benefits of the AES project: the AES project would entail a USD 600 million investment, three times the size of the closest competition, with attendant benefits for government tax revenue, export promotion, foreign exchange earnings, regional integration, energy diversification and competitiveness of Honduran industry.

¶16. (C) GOH officials, however, have not been in agreement with this concept. In conversations with Ambassador and DCM over the last few months, they have repeatedly emphasized that the bids need to be decided on the basis of the evaluation criteria established in the tender package. This argument is somewhat disingenuous. ENEE is a state-owned company and should have designed evaluation criteria that would attract the best possible project.

PUBLIC REACTION AND PRESS COVERAGE

¶17. (U) Reporting on this issue ranges from straight reporting to wait-and-see to critical. El Heraldo and La Prensa have been especially caustic, reporting that the winning company had failed to meet the requirements of the solicitation and that it should never have been allowed to participate. Reporting on the Ambassador's comments to media following his November 18 meeting with Cosenza and Medina, an HRN radio editorial agreed with the Ambassador that the decision could have an adverse impact on foreign investment and would make it more difficult for average citizens to receive a low-priced, efficient and environmentally clean energy system. HRN also said that it had warned people that various sectors of society had an interest in having the contract go to Lufussa, in spite of its failure to comply with the norms. The program director of Hoy Mismo, a widely respected national television news program, discussed the Ambassador's comments with COHEP president Regalado on the evening program yesterday. The director said that there were many questions about the process, among them the question of who had appointed the Commission on Transparency and what their qualifications were. He asked why COHEP was not asking some of the same questions about the process and was told that the government had assured COHEP that the process was transparent and fair.

¶18. (U) An editorial in his newspaper, Tiempo, by Jaime Rosenthal -- Congressional deputy, businessman and long-time

critic of the AES project -- predicted that within a year, the government would open another bidding process for an additional 200 megawatts, since he doesn't think that Lufussa can produce additional electricity with the outdated plants that they will have to continue using. He also said that a culture of suspicion is the sad reality of Honduras and worse, that the trials take place in the media, (not in the courts).

NEXT STEPS OPEN TO AES

¶19. (C) AES and other bidders have the right to appeal the tender award within five to ten days of the official notification of the result. The appeal would be decided by the Board of Directors of ENEE. Once the appeal is received, ENEE would have 40 to 60 days to decide on the motion. Once administrative procedures are completed, AES would be free to present its case to the lower courts and eventually the Supreme Court. (Note: the periods and procedures listed here are imprecise because attorneys are uncertain of the effect of a newly adopted Simplification of Administrative Procedures law, which is only now entering into force).

¶20. (C) Upon announcement of the decision on November 15, members of the transparency committee took it upon themselves to discourage any challenges by losing companies. AES has taken exception to this action. Luis Cosenza told Ambassador on November 18 that this discouragement of appeals was regrettable. The GOH reasserted the right of all bidders to pursue potential administrative and legal avenues.

¶21. (C) AES Honduras representatives are in close and frequent contact with the Embassy. They have asked for continued support and advocacy, and in particular, to highlight in our public statements our concerns about potential discrepancies. While their first impulse is to appeal the decision both administratively and legally, company representatives also are starting to think about creative redress solutions that could be negotiated (such as a second tender offer for fuel sources other than bunker and diesel).

EMBASSY COMMENT AND RECOMMENDATION

¶22. (C) The Embassy has always viewed this electricity contract as a bellwether project. If done correctly, the government's management of this process could have held the potential to reduce electricity costs dramatically, improve government finances, improve Honduran competitiveness, provide a large infusion of investment at a time of stagnant economic activity, and in addition demonstrate to the inward looking private sector that rent-seeking behavior would no longer be tolerated.

¶23. (C) Instead, the GOH has now painted itself into a corner from which no easy escape appears possible. First, by failing to provide clear leadership and guidance in the development of the evaluation criteria, the GOH has allowed ENEE to tilt the playing field toward the domestic companies. Representatives of Duke Energy, another U.S. company that had been following the tender with interest, told then-Ambassador Almaguer in March that the company would probably not participate in the tender because of this tendency (and Duke in fact decided not to bid). Second, by allowing Lufussa to win the bid despite an obvious attempt to escape a commitment to build the costly transmission lines, the GOH seriously discredits government procurement rules. Third, by not making available the data on which the evaluated prices were determined, the government has raised the specter of real manipulation of the numbers (with the collusion of all parts of the GOH) while at the same time undermining its constant assertions that the process was transparent. Fourth, the GOH has requested USG assistance on many economic fronts (a donation of wheat, help in urging flexibility with the IMF, technical assistance in trade capacity building, money laundering, tax administration, and in a variety of other fields) at the same time that it appears to be placing domestic political accommodation above fairness to U.S. investors.

¶24. (C) Embassy recommends that the USG support AES in its challenge of the bid results. The USG should be supportive of AES' attempt to obtain the documentation underlining the ENEE decision and continue to highlight publicly our questions about the fairness of the process. We will also encourage the GOH to review the decision carefully and to be willing to overturn it if mistakes were made. Allegations of impropriety should be investigated by the GOH ambitiously. While Post does not necessarily recommend a direct linkage between this issue and USG assistance or support with international financial institutions, it would be helpful to delay any announcements of new assistance or initiatives at

this time.
PALMER